BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of Department of Enforcement, Complainant, vs. Davrey Financial Services, Inc. Tacoma, WA, and Pravin R. Davrey Tacoma, WA, Respondents.	DECISION Complaint No. C3B020015 Dated: September 7, 2004

Respondents failed to maintain accurate books and records and conducted business with insufficient net capital. Respondents violated NASD advertising rules by participating in a television advertisement that contained exaggerated, unwarranted, and misleading statements and omitted requisite disclosures pertaining to options. Held, Hearing Panel's findings of violations are affirmed and sanctions are modified.

Appearances

For the Complainant: David Utevsky, Esq., NASD Department of Enforcement.

For the Respondents: H. Troy Romero, Esq., Justin D. Park, Esq., and Tolan Furusho, Esq.

Opinion

Respondents Davrey Financial Services, Inc. ("Davrey Financial" or "the Firm") and Pravin R. Davrey ("Davrey") (together, the "respondents") appeal an August 11, 2003 decision of an NASD Hearing Panel. The Hearing Panel held that the respondents failed to maintain accurate books and records and conducted a securities business with insufficient net capital in violation of SEC Rules 17a-3 and 17a-4 and NASD Conduct Rules 2110 and 3110. The Hearing Panel also found that the respondents violated NASD Conduct Rules 2110 and 2210 when Davrey appeared on a television call-in program ("the Infomercial") related to options trading

that included misleading information. The Firm paid for Davrey's appearance on the broadcast. Additionally, the Hearing Panel found that the respondents failed to include in the Infomercial the required disclosures and warning statements concerning options trading and to pre-file the Infomercial with NASD's Advertising Regulation Department ("Advertising Department"), in violation of NASD Conduct Rules 2110 and 2220.

We affirm the Hearing Panel's findings of violations, but modify the sanctions. For the books and records and net capital violations, we suspend Davrey for two years from acting as a financial and operations principal ("FINOP") and as a general securities principal and require Davrey to requalify as a FINOP and general securities principal. We also censure the Firm and impose a $15,000 fine. For the advertising violations, we suspend Davrey for two years from acting as a general securities principal and as a general securities representative. We censure the Firm and impose a $20,000 fine. Additionally, we order the respondents to submit all proposed advertising to the Advertising Department for approval prior to use for a period of two years. We also assess hearing and appeal costs on the Firm.

I. Background

Davrey entered the securities industry in 1992, as a general securities representative and became a general securities principal, an options principal, and a FINOP in 1995. Davrey founded Davrey Financial in April 1995. Davrey is currently associated with Lloyd, Scott, & Valenti, Ltd., which is an NASD member firm.

Davrey Financial became a member of NASD in December 1995. In May 2003, NASD suspended the Firm's membership for failing to file an annual audit report. The Firm operated as a $5,000 broker-dealer and was located in Tacoma, Washington. Davrey had been a controlling shareholder of the Firm since 1995. Davrey served as the Firm's president, chief executive officer, chief financial officer, compliance officer, and FINOP until January 2003.

II. Procedural History

On August 9, 2002, the Department of Enforcement ("Enforcement") filed an eight-cause complaint against Davrey and the Firm. On September 25, 2002, the respondents admitted to the violations as alleged in causes one (failing to record accurately Firm liabilities in books and records) and two (operating a securities business without sufficient net capital), but argued that the violations were unintentional. Respondents denied the remaining allegations in the complaint. Shortly thereafter, Enforcement learned that Davrey had filed a voluntary petition in bankruptcy. In response, the Hearing Officer stayed the proceeding against Davrey and continued the case against the Firm. Despite the case being stayed against Davrey, the respondents filed an amended answer on November 15, 2002, in which they again admitted the books and records and net capital violations, as alleged in causes one and two of the complaint. On January 2, 2003, the United States Bankruptcy Court for the Western District of Washington entered an order permitting this matter to proceed against Davrey; subsequently, the Hearing Officer vacated the stay against Davrey.

On January 6, 2003, Enforcement filed a motion for partial summary disposition on causes one, two, and four based on the respondents' admissions in their answers. Respondents filed a response to the motion, in which they did not dispute the facts as set forth by Enforcement, but contended that respondents had not understood that they would be prejudiced by their admissions. The Hearing Panel granted the motion in part, finding respondents liable for the violations alleged in causes one and two. A hearing was held on May 13, 2003, as to the allegations in causes three through eight and sanctions. On August 11, 2003, the Hearing Panel issued its decision, finding that respondents engaged in the misconduct as alleged in the complaint. This appeal followed.

III. Facts

A. Books and Records and Net Capital

In April 1999, the Firm, acting through Davrey, entered into two stock redemption agreements with two former shareholders. The Firm agreed to redeem shares of preferred stock, and Davrey personally guaranteed a portion of the payments made to the shareholders. The Firm began making monthly payments out of its operating account to the shareholders in accordance with the redemption agreements at the end of April 1999, but neglected to record the recurring liability on the Firm's books and records. An NASD examiner discovered the two redemption agreements during a routine examination and determined that the Firm had not recorded the payments to the shareholders as a corporate liability. NASD staff determined that the Firm incorrectly calculated and reported its net capital between April 1999 and August 2000, which resulted in the Firm operating with insufficient net capital on eight occasions during that 16-month period. NASD staff further discovered that Davrey Financial was suffering from financial losses and requested that the Firm file an accelerated FOCUS report for December 2001. That FOCUS Report documented that the Firm had operated with insufficient net capital in November and December 2001 as a result of operating losses.

At the hearing below, Davrey testified that he believed that the liabilities under the redemption agreements were his alone, and not the Firm's, because he personally guaranteed to purchase the shares. In addition, Davrey testified that he received reduced commissions from the Firm in exchange for the Firm offsetting Davrey's obligation to the shareholders under the redemption agreements. Davrey stated that he told the Firm's accountant to structure the redemption agreements such that the liability was his personal obligation and that he relied on the Firm's accountant to prepare the agreements to reflect Davrey's intent. Davrey later acknowledged, however, that the accountant never advised him that the obligation under the redemption agreements was a personal obligation. Davrey conceded that he should have reported the redemption agreements as a corporate liability on the Firm's books and records and in calculating the Firm's net capital.

B. Television Advertisement

In November 1999, Davrey appeared on television in the Infomercial, which was titled "You're on the Line" and aired on a local business channel in Los Angeles, California. The Firm paid $4,000 for Davrey's appearance. During the Infomercial, Davrey answered questions posed

to him by the program's host and also answered questions from persons calling into the show. Throughout the Infomercial, Davrey promoted the Firm and solicited securities business from the public, but subsequently opened no new customer accounts and received no customer response as a result of the Infomercial.

The program was designed to attract customers to the Firm who were interested in aggressive trading strategies and particularly the strategies of Wade Cook.[1] At the beginning of the program, the host described Davrey as the stockbroker for a number of Wade Cook's staff and students.[2] Davrey characterized the Firm as one that specialized in the teachings of Wade Cook and that relied primarily upon options trading for clients.

Davrey explained to the audience that anyone could become a successful investor in the stock market if he or she followed certain tenets recommended by the Firm. According to Davrey, a successful investor must adopt the "mindset" and the "psychological traits" that Davrey recommended. In addition, Davrey promoted "aggressive trading or short-term trading," which he determined was fundamental to rapid success. He stated that to succeed, an investor must use a broker who "enjoys" and "like[s] the thrill" of aggressive trading. Davrey told viewers that this type of trading was Davrey Financial's specialty. He told viewers that an investor "cannot expect to make money by going to a broker that does not specialize in Wade Cook type strategies."

NASD learned of the Infomercial in February 2000 during a routine examination of the Firm. Davrey had represented to NASD staff that the Firm had engaged in no advertising during the prior year; however, NASD staff discovered an entry in the Firm's general ledger account with an advertising expense listed. When questioned about the entry by NASD staff, Davrey acknowledged that he had appeared on a television program, but stated that he had forgotten about it.

III. Discussion

After de novo review of the record, we affirm the Hearing Panel's findings that respondents violated SEC and NASD rules as alleged in each cause of the complaint.

---

[1] Wade Cook is a former real-estate investor and self-proclaimed stock market expert. Cook is the author of numerous books including Wall Street Money Machine and Business Buy the Bible. Cook recommends that investors leverage their existing capital by using margin. He urges investors to pay attention to companies that announce stock splits. And, he recommends buying and selling complex arrays of options, often at the same time.

[2] Davrey testified in an on-the-record interview that, at one point, Wade Cook was also one of his clients.

A. Recordkeeping and Net Capital Violations

At the outset, we find that the Hearing Panel appropriately granted Enforcement's motion for summary disposition with respect to causes one (inaccurate books and records) and two (net capital deficiencies) as alleged in the complaint. When reviewing a ruling on a motion for summary disposition, we follow Procedural Rule 9264, which states that a Hearing Panel may grant a motion for summary disposition if there is no genuine issue with regard to any material fact, and the moving party is entitled to summary disposition as a matter of law.[3] In this case, the Hearing Panel concluded that Enforcement established, and respondents did not dispute, the recordkeeping and net capital violations alleged in causes one and two of the complaint and that Enforcement was entitled to summary disposition as to these two violations as a matter of law. After conducting our own independent review of the evidence, we agree.

The first cause of action alleged that the Firm, acting through Davrey, failed to maintain accurate books and records in violation of SEC Rules 17a-3 and 17a-4 and NASD Conduct Rules 3110 and 2110.[4] Specifically, the complaint alleged that from April 30, 1999, through December 31, 2000, the Firm, acting through Davrey, failed to record as Firm liabilities the payments made pursuant to the two redemption agreements made with two former shareholders. As a result, the Firm's trial balances, net capital computations, and aggregate indebtedness were inaccurate.

The second cause of action alleged that respondents failed to comply with SEC Rule 15c3-1 and NASD Conduct Rule 2110 by conducting securities business with insufficient net capital.[5] Under SEC Rule 15c-1, a broker-dealer is required to maintain a level of net capital above an applicable minimum to ensure that sufficient liquid assets are available to meet obligations to customers and other dealers. See Dirks v. SEC, 802 F.2d 1468, 1470 n.3 (D.C. Cir. 1986); Dep't of Enforcement v. Inv. Mgmt. Corp., Complaint No. C3A010045, 2003 NASD Discip. LEXIS 47, at *17 (NAC Dec. 15, 2003).

---

[3] In addition, federal precedent related to motions for summary judgment provides relevant guidance. See Celotex Corp. v. Catrett, 477 U.S. 317, 322-23 (1986) (moving party bears the burden of demonstrating the absence of a genuine issue of material fact); Matsushita Elec. Indus. Corp. v. Zenith Radio Co., 475 U.S. 574, 586-87 (1986) (opposing party must come forward with specific facts showing a genuine issue in dispute).

[4] Conduct Rule 3110 requires members to make and preserve books and records in conformity with all rules of NASD and as prescribed by SEC Rules 17a-3 (requirement to make and keep books and records, including ledgers reflecting all assets and liabilities) and 17a-4 (requirement to preserve records required to be made pursuant to SEC Rule 17a-3).

[5] Violations of SEC rules are violations of Conduct Rule 2110. L.H. Alton & Co., 53 S.E.C. 1118, 1122 (1999); Dep't of Enforcement v. Shvarts, Complaint No. CAF980029, 2000 NASD Discip. LEXIS 6, at *12-13 (NAC June 2, 2000).

Respondents have admitted in their initial and amended answers to the complaint, in correspondence with NASD staff, and at the hearing below and on appeal before the NAC Subcommittee that the books and records and net capital violations occurred. Davrey nonetheless argues that he was not responsible for the Firm's net capital compliance because he relied upon an outside accountant to structure the redemption agreements as a personal liability that would not be recorded on the Firm's books and records. Davrey testified that he believed the redemption agreements were his liability alone because he personally guaranteed payments made to the former shareholders under the agreements. Davrey's belief is not relevant to our findings of liability for the recordkeeping and net capital violations. We will address the reasonableness of his interpretation of the redemption agreements later in this decision when we discuss sanctions.

We affirm the Hearing Panel's findings of violations with respect to causes one and two as alleged in the complaint.

B. Misleading Advertising

Enforcement alleged in cause three of the complaint that respondents made exaggerated, unwarranted, and misleading statements throughout the Infomercial, failed to disclose potential risks, and made unwarranted promises of specific results in violation of NASD Conduct Rules 2210(d)(1)(A), (B), 2210(d)(2),[6] and 2110.[7] For the reasons set forth below, we find that respondents' Infomercial was misleading and violated NASD's advertising rules as alleged by Enforcement in cause three of the complaint.

1. The Stocks to Watch List

Davrey stated during the Infomercial that when a viewer first called the Firm, the Firm would provide the caller with a list of stocks that were anticipated "to rise substantially" and "really, really take off" in the coming year. The Firm titled this document the "Stocks to Watch" list.[8] Davrey testified at an on-the-record interview and at the hearing that while he believed that

---

[6] NASD amended Conduct Rule 2210 effective on November 3, 2003. This decision references Rule 2210 as it existed prior to the November 2003 amendments. Both prior to and after the amendments, Conduct Rule 2210(d)(1) prohibits a member from making any false, exaggerated, unwarranted, or misleading statements in its communications with the public. All public communications must be based upon the principles of fair dealing and good faith, provide a sound basis for evaluating the facts discussed, and not omit material facts or qualifications that would cause the communication to be misleading in light of this context. Id. A member may not promise specific results in any communications with the public. Conduct Rule 2210(d)(2).

[7] A violation of NASD's advertising rules is also a violation of Conduct Rule 2110. Pacific On-Line Trading & Sec., Inc., Exchange Act Rel. No. 48473, 2003 SEC LEXIS 2164, at *13 (Sept. 10, 2003).

[8] The Stocks to Watch document entered into the record consists of the names of 38 stocks and their corresponding ticker symbols. The list includes no other information pertaining to each

[Footnote continued on next page]

these securities had the potential to rise in value, he also believed they might substantially lose value. The Infomercial, however, made no mention of the risk that the securities on the Stocks to Watch list could potentially decline in value. Advertisements must "disclose in a balanced way the risks and rewards of the touted investments." Jay Michael Fertman, 51 S.E.C. 943, 950 (1994). Respondents' failure to discuss the risks associated with the Stocks to Watch list was misleading in violation of Rule 2210. See Sheen Fin. Res., Inc., 52 S.E.C. 185, 190 (1995).

Referring to his list of "potentially explosive" stocks, Davrey explained to viewers that with as little as $900, they could generate substantial revenue. He promised to provide the audience, when they called Davrey Financial, with "the best way to play" each of these stocks. Davrey listed a few of his techniques, which consisted of buying stocks and options, including long-term equity anticipation securities ("LEAPS").[9] We further find that Davrey's statements that the stocks would "rise substantially," "really, really take off," and generate substantial revenue were unwarranted promises of future performance in violation of Conduct Rule 2210. See, e.g., Dep't of Enforcement v. Reynolds, Complaint No. CAF990018, 2001 NASD Discip. LEXIS 17, at *23-26 (NAC June 25, 2001) (finding statement that "[e]ven if 99% of all stocks are dragged down with the overall market, in our opinion, [this security] will be an extremely profitable exception" was an unwarranted prediction of future performance).

In sum, we find that Davrey's representations concerning the nature of the Stocks to Watch list were misleading and made unwarranted promises of the future performance of the stocks included in the list in violation of Conduct Rule 2210.

2. Davrey's Master Key to Stock Selection

Davrey also promised that callers to the Firm would receive the "Davrey Master Key," which was one of the tools that Davrey asserted would "substantially" increase an investor's percentage of trading success. Davrey represented to viewers that the Master Key had "worked very well" for the Firm and an investor could apply the Master Key to any stock. Davrey did not disclose the contents of the Master Key during the Infomercial or discuss the specifics of its application when evaluating a stock. The Master Key contained a list of terms, including "Contingent liability," "Management changes," "New marketing," and "Technicals." Davrey did not expound on the meaning of these terms or explain how an investor should utilize these terms when analyzing a security. We find that the Master Key would be meaningless to a reasonable investor, contrary to Davrey's representations during the Infomercial. See generally Dep't of Enforcement v. Pacific On-Line Trading & Sec., Inc., Complaint No. C01000037, 2002 NASD

[cont'd]
security. The document states: "This list may be added to or changed. It is of the utmost importance that you keep in touch with your broker. It is also not intended as a solicitation to buy or sell any security. Please check with your Financial Professional before investing."

[9] LEAPS are options contracts with expirations of more than nine months from the date of issuance and may last as long as two years.

Discip. LEXIS 19, at *24 (NAC Nov. 27, 2002) (applying the reasonable investor standard when determining whether advertising was misleading), aff'd, Exchange Act Rel. No. 48473, 2003 SEC LEXIS 2164 (Sept. 10, 2003).

In his investigative testimony, Davrey stated that the Master Key was intended as an outline for discussions with customers; however, Davrey failed to provide that qualification in the Infomercial and instead implied that it was an investment tool to use when selecting stocks. We find that Davrey violated Conduct Rule 2210 by making misleading representations as well as making unwarranted promises of success by representing that investors would substantially increase their success through the use of the Master Key.

3. Davrey's Book

In addition to the Stocks to Watch list and the Master Key, Davrey told viewers that they would receive a copy of his book when it became available. Davrey touted the book as containing "techniques of some of our most successful clients" who had "taken a small amount of money and made a big amount of money" using the techniques and who continued to do so. In actuality, Davrey's book did not exist when he made these statements. At the hearing, Davrey testified that the book was "99% complete" when the Infomercial aired, but that he abandoned further progress on the book after the broadcast because of a lack of response from the Infomercial and the techniques were already publicly known. Davrey later admitted that he did not have a publisher for the book. And, when asked by NASD staff to provide a draft copy or an outline of the book, Davrey was unable to do so and stated that he had discarded everything related to the book. Moreover, when questioned by Enforcement, Davrey was able to recall only one customer who had purportedly used the techniques that he had referred to in the broadcast.

We find that a reasonable investor would have interpreted Davrey's statements to mean that he had written a book when, in fact, he had not. Cf. Dist. Bus. Conduct Comm. v. Cruz, Complaint No. C8A930048, 1997 NASD Discip. LEXIS 62, at *83-84 (NBCC Oct. 31, 1997) (finding respondent's exaggerations in an advertisement related to his credentials was misleading). In addition, we find that Davrey made unwarranted promises that his investment techniques espoused in his fictitious book could result in lucrative profits. We conclude that Davrey's statements related to his book were false and misleading in violation of Conduct Rule 2210.

4. Davrey's Million-Dollar Plan

Davrey also represented to viewers that he had a "million dollar plan" in which a customer could earn $1 million in seven years after investing only $15,000 over a two-year period. The plan required a nine or 10 percent rate of return per month in order to reach Davrey's projections of $1 million. Davrey claimed that the Firm had implemented the plan for a year and "it has worked out very well this year so far." To bolster his claim, Davrey told viewers that "[s]o far [the plan has] worked out beautifully" and that he anticipated that the Firm would have "a lot of millionaire clients" in the following six years if the trend continued. Davrey cautioned viewers that earning $1 million was not guaranteed, but he went on to state "if we do 2 [$200,000] or $300,000, is that any harder to take?"

We find that Davrey's statements constituted unwarranted promises of success. When asked by NASD staff, Davrey was unable to identify any customers who had participated in the plan and was unable to document any of the results that he claimed during the broadcast. Indeed, Davrey admitted at the hearing that the plan was new around the time of the broadcast. A viewer could reasonably have interpreted Davrey's statements as promising results for those engaging in his million-dollar plan. Davrey's promise of specific results, without a reasonable basis for the promise, violates Conduct Rule 2210.

In addition, Davrey did not disclose to viewers the details of his million-dollar plan—specifically, that his million-dollar plan involved options trading and trading on margin, both of which are not suitable for all investors and involve risk. Davrey agreed during his investigative testimony, however, that trading options and trading on margin were an essential part of the million-dollar plan. We find that Davrey failed to disclose the risk that investors could lose money by using the complex trading strategies of the million-dollar plan. NASD rules require that the content of the communication, in this case the Infomercial, "must be accurate and must provide sufficient information to evaluate the facts with respect to the securities products or services discussed." Pacific On-Line Trading, 2002 NASD Discip. LEXIS 19, at *19. Here, Davrey touted the benefits of his plan without communicating the risks involved or providing sufficient information about the details of the plan to viewers.

We find that Davrey's statements failed to provide necessary risk disclosures, constituted unwarranted promises of success, and were misleading in violation of Conduct Rule 2210.

5. Customer Testimonials

Throughout the Infomercial, Davrey promised viewers that he would provide testimonials of customers who had used the Wade Cook strategies profitably when interested viewers called the Firm. NASD staff requested that Davrey provide copies of these testimonials; however, respondents never did. Davrey's response regarding the existence of the testimonials changed throughout these proceedings. Initially, in his investigative testimony, Davrey stated that the Firm, prior to the broadcast, had received a "small stack" of unsolicited letters from customers who were pleased with the Firm's trading strategies. When asked if he could recall the names of any customers who had written such letters, he was unable to do so. Subsequently, in their amended answer, respondents admitted that they had received no customer testimonials prior to the broadcast, but stated they could have obtained them if requested. At the hearing, Davrey testified that testimonials were indeed available at the time of broadcast.

The Hearing Panel found that Davrey was not credible and concluded that the testimonials did not exist. We will not disturb those findings here. Dane S. Faber, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277, at *17-18 (Feb. 10, 2004) (stressing that deference is given to initial decision maker's credibility determination based on "hearing the witnesses' testimony and observing their demeanor"). We find that Davrey's assertion that he had customer testimonials, when in fact he did not, was false and misleading and violated Conduct Rule 2210.

In sum, we find that respondents violated Conduct Rules 2210 and 2110 by making false, unwarranted, and misleading statements during the broadcast of the Infomercial.

C. Advertising Violations Related to Options

Enforcement alleged in causes four through eight of the complaint that the respondents violated Conduct Rules 2220 and 2110 by failing to follow NASD's rules pertaining to advertising options. Conduct Rule 2220 states that advertisements that discuss options are subject to heightened standards and must include specific risk disclosures. We find that respondents violated Conduct Rules 2220 and 2110 and affirm the Hearing Panel's findings of violations.

1. Prior Approval by the Advertising Department

Conduct Rule 2220(c)(1) obligates members to submit to the Advertising Department for approval every advertisement pertaining to options at least 10 days prior to use. Therefore, under the rule, respondents were required to submit an outline of the contents of the Infomercial to the Advertising Department for approval 10 days prior to the November 9, 1999 broadcast. Davrey testified in his investigative interview that, prior to the broadcast, he gave the program's host an outline of questions to ask. It is also evident from viewing the Infomercial that both Davrey and the program's host spoke from prepared notes. Davrey, however, did not submit any information related to the Infomercial to the Advertising Department.

Davrey's reasons for not submitting the information shifted throughout these proceedings. In his investigative testimony, Davrey stated he was unsure why he did not seek approval of the Infomercial. At the hearing, Davrey asserted that he believed he was not required to submit information to the Advertising Department because the Department had approved similar materials that the Firm had used in a 1996 seminar.[10] Later in his hearing testimony, Davrey stated that he believed someone else at the Firm had submitted the materials to the Advertising Department. Davrey ultimately admitted at the hearing that he should have filed the materials with the Advertising Department.

The record amply supports the finding that respondents violated Rule 2220(c)(1) as alleged in cause four of the complaint. We therefore affirm the Hearing Panel's finding of violation.

2. Options Warning Statement

Conduct Rule 2220(d)(2)(A) requires that options advertisements, such as the Infomercial, include a warning that options are not suitable for all investors. The Infomercial

---

[10] Enforcement presented the testimony of Steven O'Mara ("O'Mara"), who is a supervisor in the Advertising Department. O'Mara testified that there was no record of the respondents' submitting the seminar materials to the Advertising Department.

included no such warning despite Davrey's references to trading options throughout the broadcast.

Davrey promoted options trading as an integral investment strategy that anyone could successfully employ with the Firm's guidance. Davrey represented to the audience that Davrey Financial's clients came from "every walk of life" and presented his strategies of trading options as an appropriate investment plan for anyone. Several of Davrey's comments during the broadcast particularly targeted small investors and emphasized purported success using the Firm's recommended techniques. In reference to strategies included in his book, Davrey stated that investors had "taken a small amount of money and made a big amount of money on it." Regarding another strategy, the million-dollar plan, Davrey highlighted that the plan required only a $15,000 investment, and within seven years, an investor's account would be worth $1 million. Later in the broadcast, Davrey represented that an investor could generate "substantial revenue[ ]" from a $900 investment. These techniques relied on complex trading strategies involving options.

The record supports the finding that the Infomercial failed to include the requisite warning statement pursuant to Rule 2220(d)(2)(A). Instead, Davrey implied that risky options strategies were suitable for all investors. We affirm the Hearing Panel's finding of violation as alleged in cause five of the complaint.

3. Inadequate Statement of Risk

Conduct Rule 2220(d)(2)(A)(i) requires that an advertisement related to options be a balanced presentation. If an advertisement touts the potential advantages of options, it must also disclose the corresponding risks. Id. While Davrey did mention risks associated with trading options in the Infomercial, he did so insufficiently. We find that he failed to present a balanced presentation as required by NASD rules.

Davrey mentioned risks associated with trading options at two points during the program. Davrey explained that options trading "can be risky . . . [and] most individuals that trade options will lose money." He added that investors "should only invest in options with money [they] can afford to lose." At a later point in the broadcast in the context of discussing covered calls, Davrey stated, "you're not going to be successful . . . on all your covered calls." We conclude that these statements fall short of presenting a balanced portrayal of risk when viewing the broadcast holistically.

Rule 2220(d)(2)(A)(i) requires that "any statement referring to the potential opportunities or advantages presented by options shall be balanced by a statement of corresponding risk." (Emphasis added.) On several occasions during the Infomercial, Davrey did not disclose the risk of the strategies that he advocated. For example, Davrey stated that the use of credit spreads[11]

[11] A credit spread is an options trading strategy in which a high premium option is sold and a low premium option is bought on the same underlying security.

was "an ideal way . . . to generate cash flow," but he was silent about the risks involved in credit spreads. Later in the program, he stated that customers using his techniques had profited significantly from small investments. To further his point, Davrey provided the example of the investor who purchased a call on a $90 per share security. He stated that, to purchase 100 shares the investor would have to pay $9,000, but with an options investment as small as $900, the investor could "control the same 100 shares" and "the same profit potential could be recognized" if the security increased in value. Davrey did not balance his presentation by revealing that the investor could lose the entire amount committed to the options in a short time if the price of the stock fell or if the options contract expired worthless.

Without question, Davrey touted the opportunities for profit from aggressive short-term trading, which relied heavily on trading options, but failed to present a balanced communication by informing viewers that they "may lose the entire amount committed to options in a relatively short period of time." See Conduct Rule 2220(d)(2)(A)(i). Even when he acknowledged that most investors lose money when trading options, Davrey countered by stating "[o]ur job is to try and put you in the category that is making money." According to Davrey, the reasons that investors lost money on trading options were greed and a lack of knowledge, which could be cured by working with an experienced broker specializing in options such as him.

We affirm the Hearing Panel's finding of violation as alleged in cause six of the complaint.

4. Options Disclosure Document

Conduct Rule 2220(d)(2)(B)(i) required that Davrey provide to viewers during the broadcast the name and address of the person at the Firm from whom they could obtain a current options disclosure statement. The Infomercial contained no such disclosure. Davrey testified that the Firm provided an options disclosure statement when a potential customer contacted the Firm about trading options. Subsequent dissemination of disclosure information is insufficient as Rule 2220 requires that the "[a]dvertisement" provide the information. Cf. Pacific On-Line Trading, 2002 NASD Discip. LEXIS, at *21 (finding subsequent disclosures made after the advertisement did not cure misleading nature of advertisement and were insufficient).

Accordingly, we affirm the Hearing Panel's finding of violation as alleged in cause seven of the complaint.

5. Use of Projected Performance Figures

Conduct Rule 2220(d)(2)(B)(ii) prohibits the use of performance projections, including annualized rates of return, in any advertisement of options trading. During Davrey's discussion of covered calls, he stated that using this option strategy could provide a return on investment of "10% a month," which would be "quite a substantial return [when] compounded over a year." This statement falls squarely within the prohibition set forth by Rule 2220. Thus, we affirm the Hearing Panel's finding that respondents violated Rule 2220(d)(2)(B)(ii).

IV. Procedural Argument

Respondents claim that the Hearing Officer erroneously admitted evidence related to the trading strategies of Wade Cook. They assert that Davrey and the Firm have no connection to Wade Cook and that Enforcement's introduction of such evidence was intended to inflame the Hearing Panel. We disagree and find the Hearing Officer's evidentiary rulings proper.

Formal evidentiary rules do not apply to NASD proceedings, and the Hearing Officer has extensive latitude "in permitting evidence and testimony . . . that might be excluded on relevance grounds before other tribunals." Rita M. Malm, 52 S.E.C. 64, 75 n.37 (1994); see Procedural Rule 9145. The Hearing Officer should ensure that any evidence offered is probative. See Gary L. Greenberg, 50 S.E.C. 242, 245 (1990).

We find that the evidence related to Wade Cook is highly probative to the case. Davrey held himself and the Firm out as experts in aggressive trading as espoused by Wade Cook. During the Infomercial, Wade Cook's name is mentioned no fewer than eight times. Davrey himself refers to Wade Cook no fewer than three times. Davrey affirmed during the broadcast that many of his clients are "Wade Cook students." When responding to a caller's question asking why investors following Wade Cook's trading philosophy often fail to make money, Davrey stated "you cannot expect to make money by going to a broker who does not specialize in Wade Cook type strategies."

We also note that respondents had the opportunity to object to the admission of evidence in accordance with Procedural Rule 9263(b), but did not. We have reviewed the record in this proceeding and reject respondents' argument. We find that the Hearing Officer's admission of evidence related to Wade Cook was not unduly prejudicial to respondents; thus, the Hearing Officer's evidentiary rulings were proper.

V. Sanctions

For failing to maintain accurate books and records and permitting the Firm to operate with insufficient net capital, the Hearing Panel suspended Davrey from associating with any member in any capacity for two years and required Davrey to requalify as a FINOP. For these same violations, the Hearing Panel censured the Firm and ordered a fine of $15,000. For violations of NASD's advertising rules, the Hearing Panel suspended Davrey for two years from associating with any member in any capacity, censured the Firm, fined the Firm $20,000, and ordered that respondents submit for two years all proposed advertising for pre-use approval. We modify these sanctions for the reasons set forth below.

A. Failing to Maintain Accurate Books and Records and Sufficient Net Capital

The Hearing Panel found that the books and records and net capital violations stemmed from a common underlying cause (i.e., the respondents' failure to record the two shareholder redemption agreements as a corporate liability on the Firm's books and records) and imposed a unitary sanction for both violations. We agree with the Hearing Panel's determination that a single set of sanctions is appropriate for the violations alleged in causes one and two, and prior

precedent supports this approach to sanctions as appropriately remedial. See Inv. Mgmt. Corp., 2003 NASD Discip. LEXIS 47, at *27-28.

The NASD Sanction Guidelines ("Guidelines") for recordkeeping violations recommend a fine of $1,000 to $10,000, and a suspension of the firm and the FINOP for up to 30 business days.[12] In egregious cases, the Guidelines suggest a fine of $10,000 to $100,000, a suspension of up to two years, an expulsion of the firm, and a bar.[13] For net capital violations, the Guidelines recommend a fine of $1,000 to $50,000, and a suspension of the firm and the FINOP for up to 30 business days.[14] In egregious cases, the Guidelines suggest a lengthier suspension of up to two years, an expulsion of the firm, and a bar for the FINOP.[15]

The Guidelines list three factors to consider in determining the proper remedial sanctions for recordkeeping and net capital violations: the nature and materiality of the inaccurate information, whether the firm continued in business while knowing of deficiencies in net capital, and whether respondents attempted to conceal the deficiencies or inaccuracies.[16] We find two factors applicable and aggravating in this matter. The Firm's failure to record the redemption agreements caused the Firm to operate with insufficient net capital over a lengthy period. Thus, we find that the inaccuracy was significant and material. We also find aggravating that the Firm continued to operate while knowing of its insufficient net capital. NASD previously had explained to the Firm through a Letter of Caution in May 1999 that it was required to record liability payments made to two shareholders pursuant to a stock redemption agreement, similar to the stock redemption agreements in this case, as a corporate liability on the Firm's books and records.[17] Rather than heed that warning, respondents repeated the misconduct by treating the stock redemption agreements at issue here as a personal rather than a corporate liability.

Davrey argues that his interpretation of the redemption agreements as a personal liability was an error made in good faith. We disagree. We find that, even if true, Davrey's interpretation of the redemption agreements as anything other than a corporate liability was unreasonable for several reasons. First, Davrey was the Firm's FINOP. The FINOP's duties include "final approval and responsibility for the accuracy of financial reports submitted to any duly

---

12 Guidelines (2001 ed.) at 34 (Recordkeeping Violations).

13 Id.

14 Guidelines (2001 ed.) at 33 (Net Capital Violations).

15 Id.

16 Id. at 33-34.

17 In May 1999, NASD sent the respondents a Letter of Caution, which cited respondents for failing to maintain accurate books and records and conducting business with insufficient net capital.

established securities industry regulatory body . . . supervision of individuals who assist in the preparation of those reports, supervision of and responsibility for individuals who are involved in the actual maintenance of the member's books and records from which such reports are derived [and] any other matter involving the financial and operational management of the member." Membership and Registration Rule 1022(b)(2)(A), (C), (E) and (G). Second, Davrey admitted at the hearing that the Firm's accountant never advised him that the redemption agreements were a personal liability. Third, NASD had clarified to Davrey and the Firm previously that payments made pursuant to a stock redemption agreement (a different stock redemption agreement than the ones here) were to be recorded as a liability on the Firm's books and records. As the Firm's principal and FINOP during the relevant period, Davrey was responsible for the recordkeeping and net capital violations at issue. See James S. Pritula, 53 S.E.C. 968, 976-77 (1998); Dep't of Enforcement v. Block, Complaint No. C05990026, 2001 NASD Discip. LEXIS 35, at *19 (NAC Aug. 16, 2001). Furthermore, respondents could have requested guidance from NASD, but they did not.

We have also considered the General Principles and Principal Considerations applicable to all violations.[18] We find aggravating that respondents have a history of prior recordkeeping and net capital violations dating back to November 1996. Specifically, NASD previously cited respondents for books and records inaccuracies and net capital deficiencies in November 1996 and September 1997.[19] The Firm received a Letter of Caution from NASD in November 1996 as a result of inaccurate net capital computations. After a routine examination of the Firm, NASD staff sent the Firm a second Letter of Caution in September 1997, which stated that the Firm had failed to accurately reflect its capital structure, which resulted in materially inaccurate FOCUS Reports. In addition, respondents' misconduct at issue here endured over a long period of time and continued after NASD alerted the Firm to a net capital deficiency as a result of the redemption agreements in August 2000.

Davrey argues that he relied upon the Firm's accountant when excluding the redemption agreements from the Firm's liabilities. Davrey asserted that he was not responsible for the Firm's financial operations because he was "too busy" and was "focusing on building [his] business." Davrey's argument is unavailing. As the Firm's principal and FINOP, Davrey—not the Firm's accountant—was responsible for the accuracy of the Firm's financial reporting. See, e.g., George Lockwood Freeland, 51 S.E.C. 389, 392-93 (1993) (holding FINOP cannot shift responsibility for net capital rule compliance to others); Dist. Bus. Conduct Comm. v. Pritula, Complaint No. C07960009, 1998 NASD Discip. LEXIS 7, at *7 (NBCC Jan. 23, 1998) (stating financial principal responsible for understanding "the net capital rule and . . . apply[ing] its provisions"). Even more telling is Davrey's own admission at the hearing that the Firm's accountant never advised him to treat the redemption agreements as a personal liability.

---

[18] See Guidelines (2001 ed.) at 3-11 (General Principles Applicable to all Sanction Determinations; Principal Considerations in Determining Sanctions).

[19] In his response to the May 1999 Letter of Caution, Davrey disputed NASD's characterization of the stock redemption agreements as a corporate liability. We have not considered the May 1999 Letter of Caution as disciplinary history for purposes of sanctions.

The respondents cite to several cases in their appeal brief in support of their argument for lesser sanctions. These cases as relevant to sanctions are inapposite to the facts and circumstances found in this case. We conclude that the respondents intentionally failed to record the redemption agreements as a corporate liability on the Firm's books and records in order to evade the net capital requirement and knowingly operated with insufficient net capital.

To impress upon Davrey the full scope of his responsibilities as a principal and as a FINOP, we suspend Davrey for two years in both capacities. We also order that Davrey requalify as a principal and a FINOP before serving again in either capacity.[20] Because we find that the recordkeeping and net capital violations are tied to Davrey's duties as a supervisor, we eliminate the Hearing Panel's suspension as a general securities representative for causes one and two. In order to remediate the violations and deter any future violations, we order Davrey Financial to be censured and fined $15,000.

B. Respondents' Violations of the Advertising Rules

Like the books and records and net capital violations, the Hearing Panel found that the advertising violations stemmed from a common underlying cause (i.e., the Infomercial) and imposed a unitary sanction for causes three through eight. We agree with the Hearing Panel's determination that a single set of sanctions is appropriate for these violations.

For a failure to file advertising materials with the Advertising Department, the Guidelines suggest a fine ranging from $1,000 to $15,000 and a suspension of up to five business days.[21] In an egregious case, the Guidelines recommend imposing, for a definite period, a "pre-use" filing requirement to obtain a "no objection" letter from NASD for all proposed communications with the public.[22] For the intentional or reckless use of misleading communications, the Guidelines suggest a fine of $10,000 to $100,000 and a suspension of the firm and culpable individual for up to two years.[23]

We find two considerations bearing on sanctions listed in the Guidelines for advertising violations applicable to respondents' misconduct: whether the failure to file was inadvertent and whether the advertisement was widely circulated.[24] First, we find that the failure to file was, at a

---

[20] The order of the bankruptcy court annulling and modifying the automatic stay precludes us from imposing a fine or hearing costs upon Davrey.

[21] Guidelines (2001 ed.) at 87-89 (Communications with the Public—Late Filing, Failing to Comply with Rule Standards or Use of Misleading Communications).

[22] Id. at 87.

[23] Id. at 89.

[24] Id. at 87-88.

minimum, reckless. Davrey's reasons for not submitting the information shifted throughout these proceedings. Initially, he stated he was unsure why he did not seek approval of the Infomercial. Later he stated that he thought he was not required to submit information to the Advertising Department because of similar material he had already submitted to the Advertising Department—a claim the Advertising Department refuted. Davrey then stated that he believed someone else at the Firm had submitted the materials. In the end, Davrey conceded that he should have filed the materials with the Advertising Department. We therefore find that the respondents' failure to file their proposed advertising was not inadvertent, but reckless and egregious, and consider it an aggravating factor.

Second, we also find an aggravating factor that the Infomercial was disseminated to a wide audience because it was broadcast on television. We acknowledge that Davrey received no business as a result of the broadcast; however, the seriousness of his misleading statements and omissions of risk as well as the potential for harm are not eliminated by Davrey's lack of earnings from the broadcast. See Daniel C. Montano, 53 S.E.C. 681, 690 (1998); Pacific On-Line Trading, 2002 NASD Discip. LEXIS 19, at *34. Davrey's presentation of complex and risky options strategies as appropriate for clients from "every walk of life" is particularly troubling. The potential for loss using Davrey's strategies is significant and hardly safe for an average investor.

Several of the Principal Considerations are also relevant in assessing the appropriate remedial sanctions for respondents' misconduct. We consider an aggravating factor that Davrey attempted to conceal information from NASD.[25] Davrey denied that the Firm had engaged in any advertising when questioned by an NASD examiner during a routine examination of the Firm in February 2000. Davrey stated that he had forgotten about his television appearance, which had occurred three months earlier. We conclude, however, that Davrey's response was false and was an attempt to hide the Infomercial from NASD.

In addition, respondents have a history of advertising violations. In a November 1996 Letter of Caution, NASD cited respondents for advertising violations related to a newsletter and Internet advertising. NASD found that respondents had failed to submit the advertising for approval by the Advertising Department 10 days prior to use, to discuss the risks associated with trading options, to include the name and address of the individual from whom a current options disclosure statement could be obtained, and omitted the options suitability warning. NASD also found the advertising contained an exaggerated discussion of a "naked put." Respondents argue that we should consider their "prompt and cooperative" attention to the issues addressed by the Letter of Caution. Contrary to respondents' assertion, cooperation with NASD after it issues a Letter of Caution is not mitigating. Rather, respondents' history of a failure to comply with the very rules at issue in this proceeding is an aggravating factor. See Sheen, 52 S.E.C. at 193.

For these reasons, we suspend Davrey for two years as a general securities principal and as a registered representative. We affirm the Hearing Panel's imposition of sanctions as to the

---

[25] See Guidelines at 9.

Firm; thus, the Firm is censured and fined $20,000. We also affirm the requirement that both respondents file for two years all their proposed advertising with the Advertising Department for "pre-use" approval.

* * * *

Accordingly, for causes one and two, we suspend Davrey for two years as a principal and as a FINOP and require him to requalify in both capacities. Davrey Financial is censured and fined $15,000. For causes three through eight, we suspend Davrey as a principal and as a representative for two years. Davrey Financial is censured and fined $20,000. Each of the suspensions that we impose upon Davrey shall run concurrently. Both respondents are required to file all advertising with the Advertising Department for pre-use approval for two years. The Firm is ordered to pay hearing costs of $1,933.42 and appeal costs of $1,219.29.[26]

On Behalf of the National Adjudicatory Council,

_____

Barbara Z. Sweeney, Senior Vice President
and Corporate Secretary

---

[26] We have considered and reject without discussion all other arguments of the parties.

Pursuant to NASD Procedural Rule 8320, any member that fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for nonpayment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for nonpayment.